

**BEFORE THE RHODE ISLAND
PUBLIC UTILITIES COMMISSION**

Verizon Rhode Island)
Alternative Regulation Plan)
)

Docket No.: 3445

DIRECT TESTIMONY OF

DR. AUGUST H. ANKUM

On behalf of

CONVERSENT COMMUNICATIONS OF RHODE ISLAND, LLC

September 20, 2002

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Attachments

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1 **INTRODUCTION**
2

3 **Q. PLEASE STATE YOUR NAME, OCCUPATION AND BUSINESS**
4 **ADDRESS.**

5 A. My name is Dr. August H. Ankum. I am a Senior Vice President at QSI
6 Consulting, Inc., a consulting firm specializing in economics and
7 telecommunications issues. My business address is 1261 North Paulina, Suite #8,
8 Chicago, IL 60622.
9

10 **Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND**
11 **WORK EXPERIENCE.**

12 A. I received a Ph.D. in Economics from the University of Texas at Austin in 1992,
13 an M.A. in Economics from the University of Texas at Austin in 1987, and a B.A.
14 in Economics from Quincy College, Illinois, in 1982.
15

16 My professional background covers work experiences in private industry and at
17 state regulatory agencies. As a consultant, I have worked with large companies,
18 such as AT&T, AT&T Wireless and MCI WorldCom ("MCIW"), as well as with
19 smaller carriers, including a variety of competitive local exchange carriers
20 ("CLECs") and wireless carriers. I have worked on many of the arbitration
21 proceedings between new entrants and incumbent local exchange carriers
22 ("ILECs"). Specifically, I have been involved in arbitrations between new

entrants and NYNEX, Bell Atlantic, US West, BellSouth, Ameritech, SBC, GTE and Puerto Rico Telephone. Prior to practicing as a telecommunications consultant, I worked for MCI Telecommunications Corporation (“MCI”) as a senior economist. At MCI, I provided expert witness testimony and conducted economic analyses for internal purposes. Before I joined MCI in early 1995, I worked for Teleport Communications Group, Inc. (“TCG”), as a Manager in the Regulatory and External Affairs Division. In this capacity, I testified on behalf of TCG in proceedings concerning local exchange competition issues, such as Ameritech’s Customer First proceeding in Illinois. From 1986 until early 1994, I was employed as an economist by the Public Utility Commission of Texas (“PUCT”) where I worked on a variety of electric power and telecommunications issues. During my last year at the PUCT I held the position of chief economist. Prior to joining the PUCT, I taught undergraduate courses in economics as an Assistant Instructor at the University of Texas from 1984 to 1986.

A list of proceedings in which I have filed testimony is attached hereto as Exhibit AHA-1.

1

2 A. **PURPOSE**

3

4

5 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

6 A. My testimony will address Verizon's request for pricing flexibility, its Alternative
7 Regulation Plan and the testimony of some of the witnesses filed in this proceeding. I
8 will discuss the shortcomings of VZ's proposal and suggest modifications necessary to
9 ensure that the plan is in the public interest.

10

11 **B. SUMMARY AND RECOMMENDATIONS**

12

13

14 **Q. PLEASE SUMMARIZE YOUR TESTIMONY.**

15 A. All of Verizon's testimony focuses on (a) the need for Verizon to obtain pricing
16 flexibility and (b) the claim that Verizon's customers in Rhode Island will be
17 protected against undue price increases by the presence of competition. I will take
18 issue with both assertions.

19

20 First, I will address Verizon's claim that it requires pricing flexibility in the face of
21 growing competition. I will argue that while it is true that in competitive markets
22 companies price flexibly to respond to competition, no company will need flexibility
23 to systematically price its products *below* costs.

24

1 Second, I will argue that Verizon's request for pricing flexibility is tantamount to a
2 request to receive full control over the profitability of its dependent competitors. As
3 such, Verizon's request -- while couched in innocuous terms -- is *equivalent* from a
4 policy perspective and economic perspective to a request for pricing flexibility for
5 UNE prices.

6
7 In simple terms, most CLECs live or die by the margins between the wholesale rates
8 for unbundled network elements ("UNEs") and retail rates.¹ The larger the margin
9 between the wholesale rates CLECs pay to Verizon and the retail rates they can
10 charge in the market place, the larger will be their profits -- if any - or the smaller
11 will be their losses. If that margin shrinks, so will the CLECs' ability to operate in
12 Rhode Island. Thus, if Verizon is granted the nearly unrestricted downward retail
13 flexibility it is asking for, Verizon will be able -- at will -- to increase or decrease the
14 margin available to its dependent competitors. As such, Verizon is largely in control
15 of the strength and viability of its competitors, which -- coming full circle -- are the
16 very companies that Verizon claims will protect customers from Verizon. Whatever
17 may be the merit of Verizon's arguments and testimony, the construct underlying the
18 proposed Alternative Regulation Plan is deeply flawed: *to be sure, if granted as*
19 *proposed, it will "place the fox in charge of the hen house."*

¹ A possible exception may be CLECs that are affiliated with a cable company, such as Cox Communications. Such a CLEC may be able to obtain access to the outside plant of its cable affiliate and therefore not be dependent on the ILEC to the same degree as CLECs that are not affiliated with a cable franchise.

1

2 Last, in order to place Verizon's request for pricing flexibility in the larger context
3 of the state of the competitive telecommunications industry, I present the results of a
4 financial analysis of the major CLECs, including the larger IXCs. This analysis
5 shows that the CLEC industry is in no shape to withstand possible efforts of Verizon
6 at anti-competitive pricing practices -- which Verizon will be able to *fruitfully*
7 engage in under its Alternative Regulation Plan.

8

9 **Q. WHAT ARE YOUR RECOMMENDATIONS?**

10 A. Given the dependent nature of the CLEC industry, I believe that it is premature to
11 grant Verizon the nearly unrestricted pricing flexibility it is asking for under its
12 Alternative Regulation Plan. Most dangerous is the unrestricted pricing flexibility
13 that would allow Verizon to selectively approach customers in wire centers and
14 geographic areas served by CLECs -- and regain its lost customers by offering them
15 excessively² attractive packages that CLECs cannot match. Such a policy would
16 under the current market conditions be rational for Verizon but harmful to the public
17 interest.

18

19 In view of these concerns, I make the following recommendations to provide some
20 measure of protection for dependent CLECs:

² As will be discussed, companies such as VZ have an incentive in competitive situations to set prices as low as their short run marginal costs, which in many instances will be lower than TELRIC based prices.

- 1 -- VZ should not be allowed to price-discriminate among similarly situated
2 retail customers. Any pricing proposal that VZ offers to one set of retail
3 customers, it should be required to offer to similarly situated customers.
4 This prevents VZ from selectively targeting just CLEC customers with
5 excessively inexpensive product offerings that CLECs cannot match.
6
7 -- VZ should not be allowed to lower any retail price for which it is seeking
8 pricing flexibility below a price floor set no lower than the imputed cost of
9 providing the service. (An appropriate imputation test is discussed below.)
10 This provision would limit VZ's ability to place dependent CLECs in an
11 anti-competitive price squeeze.
12
13 -- To promote facilities based competition, the Commission should order VZ to
14 cap its hot-cut non-recurring charge (the "hot-cut NRC") at a rate of no more
15 than \$35--the rate at which VZ is offering hot-cuts in New York.³
16
17 -- VZ should commit to continue to offer the set of UNEs it is currently
18 offering.
19
20 -- VZ should commit itself to introduce -- upon the request of CLECs -- in
21 Rhode Island the outcome of the NYPSC Task Force regarding the
22 promotion of competition in NY.
23

24 Further, I recommend that the imputed costs used to establish a price floor below
25 which VZ would not be allowed to set retail rates includes, at a minimum, the
26 following two cost components:

- 27 (1) *Imputed costs of all the UNEs used to provide the service.*
28 This should be calculated by multiplying the quantity of the UNEs
29 used to provide the service *times* the UNE TELRIC prices. Also
30 included should be some recognition of the non-recurring charges to
31 order UNEs.
32
33 (2) *A measure of minimum retail related costs.*
34 An appropriate proxy for these retail costs could be established by
35 using the Commission approved percentage for resale discounts. The
36 Commission should recall that the resale discount is calculated based

³ In docket 2681, VZ is proposing in its standard filing to increase the hot cut NRC in Rhode Island from the existing tariffed rate of about \$42 to \$156.58 for the first loop and \$90.72 for additional loops.

1 on VZ's retail related expenses.

2
3
4 Further, the Commission should recognize that VZ's request for pricing flexibility is
5 premature in the sense that it is precedes the Commission's TELRIC proceeding --
6 the outcome of which determines how viable competition will be in the future.
7 Optimally, VZ's Alternative Regulation Plan would not be considered until the
8 TELRIC docket has been completed. If, however, the Commission decides to
9 proceed with this docket before the TELRIC docket has been completed, VZ should
10 be required to commit itself to a number of additional provisions. They are the
11 following:

- 12 -- VZ should commit itself to a good faith effort to establish UNE prices that
13 permit efficient local competition. At a minimum, there should be a
14 rebuttable presumption that updated UNE prices be lower rather than higher
15 than current UNE prices.
16
17 -- The terms and conditions under which unbundled network elements and
18 interconnection services are available in New York are presumptively just
19 and reasonable in Rhode Island *if conditions are reasonably comparable*.
20 This means that *in those situations* VZ should commit itself to charge rates
21 no higher than those charged in New York. (For example, if certain non-
22 recurring charges are based on activities that involve the same OSS facilities
23 as used for CLECs in New York, then rates no higher than those charged by
24 VZ in New York should apply in Rhode Island.) In the TELRIC proceeding,
25 when CLECs recommend adoption of certain rates that prevail in New York
26 (Gus, is that what we are going to do in the TELRIC proceeding), VZ should
27 have the burden of proof to show that situations in Rhode Island are not
28 comparable to those in New York and demonstrate with specificity why
29 costs and rates should be higher in Rhode Island.
30

1 **II. VZ'S PROPOSAL PROVIDES NO PROTECTION FOR THE**
2 **DEVELOPING COMPETITIVE LOCAL EXCHANGE**
3 **MARKET**
4

5
6 **A. THE STANDARD FOR PRICING FLEXIBILITY SHOULD BE**
7 **STRICTER THAN FOR 271 APPROVAL**

8
9 **Q. IN DETERMINING WHETHER MARKETS ARE SUFFICIENTLY**
10 **COMPETITIVE TO GRANT VERIZON PRICING FLEXIBILITY SHOULD**
11 **THE COMMISSION USE THE SAME STANDARD AS 271 FILLING?**

12 **A.** No. The issues before the Commission in the current proceeding are different than
13 those in a 271 filling.
14

15 In a 271 filling, the focus of the Commission should be on the question of whether
16 Verizon has met the requirements of the Telecommunications Act of 1996 and
17 irreversibly opened its local exchange markets in Rhode Island to competition. The
18 Commission and the FCC found this was indeed the case. By contrast, in the current
19 proceeding, the focus is, among others, on the question of whether the level of
20 competition is sufficient to curtail Verizon's market power as a dominant provider of
21 local telecommunications services in Rhode Island. As will be discussed shortly,
22 there should be a significantly higher threshold to answer this question affirmatively.
23

B. VZ'S ABILITY TO APPLY A PRICE-SQUEEZE COULD SERIOUSLY IMPAIR THE DEVELOPMENT OF LOCAL COMPETITION

Q. IN GENERAL, GIVEN VERIZON’S POSITION AS THE DOMINANT PROVIDER, WHICH ARE THE TWO FORMS OF PRICING STRATEGIES THE COMMISSION SHOULD BE CONCERNED ABOUT?

A. In general, given Verizon's dominant position, there are two forms of pricing strategies that should concern the Commission in granting Verizon pricing flexibility. Unless appropriate rules are in place, Verizon could do either one or both of the following:

- (1) *Increase* its retail rates and earn supra normal profits at the expense of ratepayers; and/or,
- (2) *Lower* its retail rates below a relevant price floor in select circumstances to defeat competitors.⁴

It is important to note that these two pricing strategies are not mutually exclusive. To the contrary, the two strategies are most effective for Verizon if they are executed simultaneously. In that manner, Verizon would be able to fend off competitors by selectively lowering rates for certain services in certain regions where it faces some competition and/or it knows that CLECs have facilities, while remaining optimally profitable by raising rates for customers not subject to competition.

1 **Q. HAVE YOU READ VERIZON’S PROPOSALS FOR PRICING**
2 **FLEXIBILITY?**

3 A. Yes. I have read the testimonies and reviewed the Verizon Rhode Island Alternative
4 Regulation Plan. Verizon is asking the Commission for a broad grant of pricing
5 flexibility. The plan provides for important price caps and other restrictions on some
6 residential services. For business services, however, Verizon requests nearly
7 unregulated pricing flexibility; or as the Verizon puts it: “Pricing for these services
8 will be at the discretion of the Company.”⁵

9
10 **Q. IS THE CURRENT LEVEL OF COMPETITION SUFFICIENT TO**
11 **CURTAIN VERIZON’S MARKET POWER?**

12 A. No. While clearly, competition in Rhode Island is developing, it is important to note
13 that Verizon itself recognizes that, in general, the level and scope of competition is
14 still insufficient to curtail Verizon’s market power. Most notably, Verizon itself
15 proposes price caps and other restrictions on its ability to change the rates for certain
16 residential services; presumably, because market forces are not strong enough to
17 keep the company from raising such rates to increase profits.

18
19 **Q. IS MUCH OF THE COMPETITION THAT VZ POINTS TO IN ITS**
20 **TESTIMONY IN FACT COMPETITION THAT IS DEPENDENT ON VZ?**

⁴ Once VZ has defeated its competitors through anticompetitive pricing, it will be able to raise its retail rates to the detriment of ratepayers.

1 A. Yes. VZ witness A. Silvia discusses the competitive landscape in Rhode Island and
2 in doing so underscores the critical dependence of CLECs on VZ's facilities. He
3 notes:

4 Through February 2002, there were 88 collocation
5 arrangements in effect for 13 CLECs in 17 central offices.
6 CLECs have access, via their collocation arrangements, to 88%
7 of VZ RI's residential access lines and 94% of VZ RI's business
8 access lines, and 89% overall.
9

10 He then goes on to note the following:

11 Through May 2001, there were approximately 4,000 loops
12 provided as part of UNE-P combinations that include switching
13 and transport elements. By February 2002, use of UNE-P
14 facilities had grown to nearly 4,800 circuits, an increase of
15 about 20 percent over nine months.
16

17 There are many more sections in VZ's testimony that discuss CLECs being
18 dependent on VZ facilities and services.
19

20 **Q. DOES VZ'S TESTIMONY IN FACT SHOW HOW FEEBLE**
21 **COMPETITION IS?**

22 A. Yes. If UNE prices are set correctly, UNE-P should be the quickest and low cost
23 entry strategy for CLECs.⁶ Yet, by February 2002, only 4800 customers were
24 served with UNE-P in Rhode Island. Considering that in New York approximately
25 55 percent of the over 3 million customers served by CLECs are now served with

⁵ Verizon's Rhode Island Alternative Regulation Plan, paragraph D.

1 *UNE-P*,⁷ it is clear that in Rhode Island *UNE-P* is not yet an economically viable
2 strategy that the Commission can rely on to keep VZ in check. Judged by the VZ
3 filing in the TELRIC proceeding, VZ is making no efforts to relieve this problem --
4 to the contrary, unless the Commission makes significant adjustments to VZ's
5 proposed *UNE* prices, facilities-based competition too will experience an important
6 setback.⁸

7

8 **Q. SHOULD VZ'S MARKET ANALYSIS -- WHICH RELIES HEAVILY ON**
9 **911 DATA -- BE TREATED WITH SKEPTICISM?**

10 **A.** Yes. VZ's analysis relies heavily on 911 data. The company uses the 911 data to
11 establish a total number of customers served by CLECs and then subtracts certain
12 known quantities (such as customers served through resale and *UNE-P*) to arrive on
13 an "estimated" number for how customers are served by CLECs that use "their own
14 facilities." This method is troublesome.

15

16 The 911 data are proprietary and cannot be validated by intervenors. Further, it is
17 my understanding that in Massachusetts the use of the 911 data encountered
18 significant opposition from intervenors for precisely that reason. Further, it is not

⁶ Nevertheless, CLECs will follow different entry strategies based on their relative resources, strengths and expertise. For example, *UNE-P* for residential customers may be more attractive to carriers with significant name recognition.

⁷ NYPSC Case 00-C-1945, Staff Panel Testimony, p. 15.

⁸ For example, in docket 2681, VZ is proposing in its standard filing to increase the hot cut NRC in Rhode Island from the existing tariffed rate of about \$42 to \$156.58 for the first loop and \$90.72 for additional loops.

1 clear that the data list in the 911 database necessarily represent customers that are
2 served by CLECs over their own facilities. In any event, the Commission should
3 take great care not to rely on data that cannot be validated by intervenors and to
4 which only VZ has access.

5

6 **Q. IS THE CURRENT LEVEL OF COMPETITION SUFFICIENT TO**
7 **CURTAIN VERIZON'S ABILITY TO ENGAGE IN ANTICOMPETITIVE**
8 **PRICING STRATEGIES?**

9 A. Definitely not. Again, under anticompetitive pricing, Verizon would selectively
10 lower certain rates for retail services, such as business services, below a relevant
11 price floor in order to defeat competitors. Under the proposed Rhode Island
12 Alternative Regulation Plan, Verizon can engage in this type of pricing for business
13 services on *a per customer and per location basis*. It is precisely this request for
14 unrestricted pricing flexibility that will allow Verizon to control the strength and
15 viability of its competitors and thus the strength of the competitive market forces it
16 points to as protection for ratepayers in Rhode Island.

17

18 **Q. IS ANTICOMPETITIVE PRICING MOST HARMFUL TO COMPETITORS**
19 **THAT ARE DEPENDENT ON VERIZON'S UNBUNDLED NETWORK**
20 **ELEMENTS?**

21 A. Yes. While all competitors could potentially be harmed if Verizon engaged in

1 anticompetitive pricing strategies, most vulnerable are carriers such as Conversent
2 (and Choice One) that use Verizon's unbundled network elements.

3
4 Carriers that use Verizon's unbundled network elements have only a limited ability
5 to lower their prices in response to Verizon. Specifically, if Verizon lowers its prices
6 to select customers below the imputed costs of serving those customers with
7 unbundled network elements, then the dependent competitor can no longer compete
8 *profitably*: given its own costs for retailing and overhead, the competitor would pay
9 more for the unbundled network elements than it could recoup from the customer.

10
11 **Q. PLEASE EXPLAIN IN MORE DETAIL WHY THE CURRENT LEVEL OF**
12 **COMPETITION MAY TO SOME EXTENT CURTAIL VERIZON'S**
13 **ABILITY TO RAISE RATES BUT NOT VERIZON'S ABILITY TO**
14 **ENGAGE IN ANTICOMPETITIVE PRICING?**

15 A. As demonstrated by the testimony of Verizon itself, much of the competition in
16 Rhode Island remains critically dependent on Verizon's network and operations.
17 Except for resale,⁹ this type of competition may be effective to some extent in
18 curtailing Verizon's ability to raise prices in certain locations. If Verizon raises rates
19 for certain customers, then competitors that are suitably located may offer those
20 customers service – by means of unbundled network elements or over their own

⁹ As discussed presently, resellers do not pose serious competition since their ability to under-price Verizon is restricted to Verizon's resale discount.

1 facilities -- at lower prices.

2

3 These same market dynamics are useless in curtailing Verizon's ability to engage in
4 anticompetitive pricing practices. To be sure, competitors that use Verizon's
5 unbundled network elements are unable to apply the type of competitive pressures
6 needed to prevent Verizon from selectively lowering prices below certain price
7 floors.

8

9 **Q. IS THE ANTI-COMPETITIVE PRICING STRATEGY YOU ARE**
10 **REFERRING TO TYPICALLY CALLED "PRICE-SQUEEZE"?**

11 A. Yes.

12

13 **Q. PLEASE DEFINE AND DISCUSS THE CONCEPT OF A PRICE**
14 **SQUEEZE?**

15 A. A price squeeze concerns a situation in which a vertically integrated firm (such as
16 VZ) competes against companies (such as CLECs) in retail markets while
17 controlling prices in wholesale markets for critical inputs that its competitors are
18 dependent upon. In this situation, the vertically integrated firm can use the price
19 squeeze as an anticompetitive device by raising the prices for the monopoly inputs
20 (i.e., the port, loop, local switching and shared transport¹⁰) thus squeezing the
21 dependent competitors' margins between retail rates and wholesale rates reducing

1 their ability to recover their costs. This strategy is called a price squeeze and can

2 more formally be defined as follows:

3 Considering a situation in which a monopoly supplier is
4 integrated downstream, a price squeeze [is] the situation in
5 which "the monopoly input supplier charges a price for the
6 input to its downstream competitors that is so high they
7 *cannot profitably* sell the downstream product in
8 competition with the integrated firm¹¹" (Emphasis added.)
9

10 The FCC discusses the price-squeeze strategy and notes that it occurs when a
11 dominant firm with downstream competitors that rely on facilities and services from
12 the dominant firm is "charging prices for inputs that preclude[] competition from
13 firms relying on those inputs."¹²

14
15 **Q. WHAT LEVEL OF COMPETITION IS REQUIRED BEFORE VERIZON**
16 **WILL NO LONGER BE ABLE TO ENGAGE IN ANTICOMPETITIVE**
17 **PRICING?**

18 A. As long as Verizon is a dominant firm, it will always be in a position to increase
19 rates for some customers and to lower rates for other customers in order to defeat
20 competitors *without endangering its own profitability*. Competition is present
21 only for select customers in select regions of the state. Indeed, not even Verizon
22 is arguing at this point that the company is no longer dominant in local exchange

¹⁰ The rates for these UNEs are currently under investigation by the Commission in Docket No. 2681.

¹¹ Jean Tirole, "The Theory of Industrial Organization," The MIT Press, Cambridge, Massachusetts, 1988, page 186. Tirole quotes from Joskow, P. 1985. Mixing Regulatory and Antitrust Policies in the Electric

1 markets in Rhode Island. In view of this, it is simply premature to grant the
2 company the broad pricing flexibility it seeks.

3
4 **Q. WHAT IS THE MOST INSIDIOUS ASPECT OF VZ'S PRICING**
5 **FLEXIBILITY REQUEST?**

6 A. Most insidious in perhaps Verizon requests for nearly unregulated pricing
7 flexibility for business services: as VZ puts it: "Pricing for these services will be
8 at the discretion of the Company."¹³

9
10 **Q. WHY IS THIS TYPE OF UNRESTRICTED PRICING FLEXIBILITY SO**
11 **INSIDIOUS?**

12 A. This type of pricing flexibility will allow VZ to selectively target the customers it
13 lost to CLECs. VZ, of course, knows the identity and location of the customers
14 that it loses to CLECs. Moreover, the Commission should recognize that to the
15 extent that CLECs serve their customers by collocating in VZ central offices and
16 leasing UNE loops from VZ, VZ knows the general location and nature (small
17 business, large business or residential) of the CLEC customers. While there are
18 restrictions on VZ's ability to use information obtained as part of providing UNEs
19 to CLECs for competitive purposes, simple visual observation of a floor with

Power Industry: The Price Squeeze and Retail Market Competition. In "Antitrust and Regulation: Essays in Memory of John J. McGowan," ed. F. Fisher. City: Publisher.

¹² Sprint v. FCC 274 F.3d 549, 551 (2001).

¹³ Verizon's Rhode Island Alternative Regulation Plan, paragraph D.

1 collocation spaces will speak volumes to experienced telecommunications
2 experts. Also, VZ's personnel, that has worked for the company sometimes for
3 decades, will have impressive accumulated institutional knowledge about VZ's
4 service area. They know what customers reside in what buildings and which
5 other carriers operate in those buildings. That is, there is simply no way to
6 insulate valuable competitive information in a large organization that is motivated
7 by a common interest and purpose. In any event, VZ will be able to compose, one
8 way or another, the necessary information to approach select CLEC customers
9 and put together just for these customers service packages that are more attractive
10 than those offered by the CLEC. Indeed, VZ will be able to offer service
11 packages at prices that CLECs simply cannot match.

12
13 **Q. PLEASE EXPLAIN WHY CLECS WILL NOT BE ABLE TO MATCH VZ**
14 **IF IT OFFERS AGGRESSIVELY PRICED SERVICE PACKAGES TO**
15 **SELECT CLEC CUSTOMERS.**

16 A. Given the scope of VZ's rate-base and network, the company will be able to
17 engage in short-run marginal cost pricing for these select customers and still
18 remain profitable as a company overall. By contrast, most CLECs are already in a
19 precarious financial position and will be unable to match VZ in such pricing
20 practices.

1 This is particularly true if VZ does a full-scale assault on a CLEC's customers in
2 a particular location, such as customers served from a central office in which a
3 CLEC is collocated. Where it concerns a full-scale assault, the CLEC will simply
4 not be able to (a) match VZ's short term marginal cost pricing *and* (b) recover its
5 overhead and other non-incremental costs. Thus, while VZ may have to offer low
6 prices (which may not recover overhead costs) to certain customers, these
7 customers will represent only a *small percentage* of VZ's total customers. By
8 contrast, these customers will represent a *large and significant percentage* of the
9 CLEC's customer base. This fundamental asymmetry allows VZ to engage in
10 aggressive types of marginal cost pricing that may not recover overhead costs but
11 prohibits CLECs from following suit and retaining their customers.

12
13 Further, given the large sunk costs at stake, CLECs will be seriously hurt if they
14 have to retreat from a wire-center where they have invested large sums of money
15 to build out collocation cages. Moreover, if VZ is successful in forcing CLECs to
16 retreat in certain wire-centers and relinquish their collocation spaces, CLECs will
17 think twice before they commit to new investments in Rhode Island. That is, the
18 further development of local competition will be seriously impaired. Clearly, the
19 Commission should not grant VZ's request for unrestricted pricing flexibility.

20
21 **Q. IN GENERAL, DO COMPANIES SUCH AS VZ HAVE AN INCENTIVE IN**
22 **COMPETITIVE SITUATIONS TO REDUCE PRICES AS LOW AS**

1 **SHORT RUN MARGINAL COST, WHICH IN MANY INSTANCES WILL**
2 **BE LOWER THAN TELRIC-BASED RATES?**

3 A. Yes. The Commission should recognize that, in competitive situations, VZ will
4 have an incentive to reduce prices as low as short run marginal costs if such price
5 reductions are necessary to win back customers. This strategy of lowering prices
6 for select customers is entirely rational to pursue for the company and consistent
7 with profit maximizing behavior.

8
9 The Commission should also recognize, however, that short run marginal costs
10 are often considerably below TELRIC based prices. For example, if VZ's loop
11 facilities on a particular route have been constructed 30 to 40 years ago and are
12 fully depreciated, then the short run marginal costs of using these facilities is near
13 zero. Thus in a competitive situation, VZ will be able to reduce its prices to a
14 level significantly below the TELRIC of the loop facilities, which assumes that
15 facilities are *newly* constructed. It is clear, therefore, that in many instances VZ
16 will be able to offer customers packages that are prices significantly below even
17 the most competitive offerings of the CLECs.

18

19 **Q. BUT, ISN'T COMPETITION SUPPOSED TO DRIVE DOWN PRICES?**

20 A. Yes, competition is supposed to bring lower prices and/or higher quality of
21 service to ratepayers in Rhode Island. However, the strategy that I just describe
22 will not bring lower prices to most of the ratepayers in Rhode Island. Rather,

1 price reductions will benefit only select customers: the ones that VZ has decided
2 it wants to win back from CLECs.

3

4 Further, it is important for the Commission to recognize that any possible price
5 reductions for select customers will only confer short-term benefits. VZ will
6 reduce prices is not just to win back certain customers but to generally curtail and
7 undermine competition. Thus, as over time VZ's anti-competitive¹⁴ pricing
8 practices would certainly ease competitive pressures, VZ is free to raise rates,
9 erasing whatever short-term benefits select customers might have experienced.
10 These dynamics can hardly be argued to be in the public interest: as a public
11 policy, it would "penny wise, pound foolish."

12

13

14 C. VZ'S PROPOSALS HAVE BEEN MODIFIED IN OTHER
15 JURISDICTIONS TO PROTECT COMPETITION

16

17 Q. ARE YOU FAMILIAR WITH VZ'S ALTERNATIVE REGULATION
18 PROPOSAL AND TESTIMONY FILED IN OTHER JURISDICTIONS,
19 SUCH AS NEW YORK?

20 A. Yes. I am generally familiar with VZ's Alternative Regulation filing in New
21 York. Before reaching a settlement with the Staff and other parties in New York,

1 VZ's proposal in that jurisdiction was very much the same as the proposal the
2 company is presenting here in Rhode Island. The Alternative Regulation
3 ultimately approved in New York, however, was modified significantly.
4

5 **Q. WHAT PROMPTED THE NEW YORK COMMISSION AND**
6 **INTERVENORS TO SIGNIFICANTLY MODIFY VZ'S PROPOSAL IN**
7 **NEW YORK?**

8 A. The New York Commission recognized if it is going to rely on competition to
9 protect the ratepayers of New York, then it has to ensure that competition itself is
10 vibrant and protected. In view of this, the Staff recommended and the
11 Commission adopted certain provisions that would further strengthen and protect
12 competitive developments in New York.
13

14 **Q. WHAT PROVISIONS DID THE NEW YORK COMMISSION ADOPT TO**
15 **STRENGTHEN AND PROTECT?**

16 A. The New York Commission Staff recommended and the Commission adopted a
17 large number of provisions to guarantee the further development of competition in
18 New York. They are worth discussing in some detail.
19

¹⁴ As discussed previously, for VZ to reduce prices below comparable TELRIC based prices is tantamount to an anti-competitive price squeeze.

1 First, the Staff recommended restrictions on downward pricing flexibility to limit
2 VZ's ability to engage in anti-competitive pricing strategies. For example, on
3 page 54 of the Staff Panel Testimony, Staff discusses that VZ's downward pricing
4 flexibility should be restricted by a price floor (equal to the company's
5 incremental costs) and an imputation test:

6

7 The company will have the option to increase, decrease, or
8 maintain current rate levels during the term of the plan as
9 long as rates at least cover their relevant incremental costs
10 and comply with several other conditions. *Downward*
11 *pricing flexibility is limited only to a rate equal to the*
12 *company's incremental cost and usage-based offerings*
13 *must pass an imputation standard.* Overall revenue
14 increases associated with pricing flexibility are capped at
15 3% on an annualized basis each Plan year.¹⁵
16

17 Again, the restriction to set prices below a relevant price floor limits VZ's ability
18 to engage in anti-competitive pricing strategies at the expense of competition.

19

20 The New York Staff went on to describe a number of other provisions that would
21 strengthen and protect competition in New York:¹⁶

22 . In the Joint Proposal Verizon agrees to
23 participate in a series of industry task forces
24 to deal with issues identified by CLECs as
25 roadblocks to more permanent and vibrant
26 competition. The task forces will be charged
27 with identifying major issues and seeking
28 solutions for the following issue areas:

¹⁵ NYPSC Case 00-C-1945, Staff Panel Testimony, p. 53.

¹⁶ Id., pp. 23 - 24.

1. Eliminating bottlenecks to migrating customers from UNE-P to competing carriers' facilities.
2. Establishing procedures to facilitate provisioning of service when a UNE order is rejected by Verizon due to lack of facilities.
3. Establishing procedures and/or products that enhance competitors' ability to provide service in locations otherwise barred to them.
4. Establishing reasonable and reciprocal billing and collection terms and procedures between Verizon and its competitors.

The Staff then went on to discuss a number of other important provisions to protect competitors:¹⁷

In addition to the task force issues and the stability on UNE prices, the Joint Proposal provides the following competitive enhancements:

1. A non-recurring charge of \$35.00 for UNE hot cuts as opposed to the approximate \$185.00 charge contained in the Commission's UNE decision.
2. Availability of UNE-P to competitors to serve small business customers notwithstanding the restrictions permitted by the Pre-Filing Statement and FCC rules.
3. Elimination of potential charges to competitors associated with exogenous cost claims by Verizon.

Last, in an effort to create more stable and secure conditions for CLECs, Staff noted that VZ had agreed to not challenge certain important NYPSC decisions:¹⁸

¹⁷ Id., p.24.

¹⁸ Id., p.24.

1 It is also worth noting that the Joint Proposal
2 provides CLECs added stability in that the key
3 UNE prices are as specified in the Plan and
4 Verizon has agreed not to challenge the
5 Commission's UNE rate decision. This should
6 enhance CLECs' ability to plan.
7

8 It is clear from this discussion that the NYPSC has serious concerns about VZ's
9 request for unfettered pricing flexibility and that it put in place a number of
10 important provisions to protect and strengthen competition. *It is also important to*
11 *note that VZ was willing to agree to these provisions.*
12

13 **Q. IS THE REQUIREMENT THAT VZ OFFERS HOT CUTS AT \$35 AN**
14 **IMPORTANT COMPONENT OF THE OVERALL PLAN?**

15 A. Yes. While the telecommunications Act of 1996 provides for a number of
16 market-entry strategies (facilities based, UNEs and resale), the long-term
17 survivability of local competition requires that facilities based competition is
18 possible and viable. To this purpose, it is essential that facilities based CLECs
19 are able to migrate VZ customers onto their own switch facilities at terms and
20 conditions that are efficient and economical. In New York, the Commission had
21 raised a serious barrier-to-entry by setting a rate of \$185 for Hot Cuts. This
22 barrier-to-entry was effectively reduced by lowering the rate to \$35, as suggested
23 by Staff. In the words of the NYPSC Staff:¹⁹

¹⁹ Id., p. 10.

1 The Commission had, in its UNE decision, increased this charge from
2 about \$24 to more than \$185. This increase would have created a serious
3 barrier to those CLECs trying to migrate their customer bases away from
4 Verizon's switches. By reducing the charge in the Plan from the \$185
5 level to \$35, we successfully removed this barrier.
6
7
8
9
10

1
2 **III. THE RHODE ISLAND PUC SHOULD ADOPT PROVISIONS**
3 **TO PROTECT COMPETITION**
4

5 **A. COMPETITION IN RHODE ISLAND REQUIRES AS MUCH**
6 **PROTECTION AS IT DOES IN NEW YORK**

7
8 **Q. SHOULD THE COMMISSION MODIFY VZ'S PROPOSAL AND PUT IN**
9 **PLACE PROVISIONS TO PROTECT AND STRENGTHEN**
10 **COMPETITION IN RHODE ISLAND?**

11 A. Yes. It is clear from VZ's testimony that its Alternative Regulation Plan will only
12 generate positive results for society at large *if and only if* there is competition in
13 Rhode Island strong enough to discipline all market participants, including and
14 most importantly VZ. It is also clear that -- as proposed -- VZ's Alternative
15 Regulation Plan leaves competitors dangerously exposed to the whims of and
16 possible anti-competitive pricing by VZ, thus undermining the very premise that
17 motivates and justifies any alternative regulation proposal. As discussed, the
18 NYPSC recognized this flaw in VZ's proposals and so should this Commission.

19
20 **Q. IF COMPETITION IN NEW YORK REQUIRES PROTECTION FROM**
21 **VZ WOULD COMPETITION IN RHODE ISLAND REQUIRE AT LEAST**
22 **AS MUCH PROTECTION?**

23 A. Yes. By virtue of its size, population density and high concentration of business
24 customers, New York is possibly the most attractive, important and vibrant

1 telecommunications market in the country. Yet, even in New York, competition
2 remains critically dependent on VZ and if left unprotected could be harmed and
3 even fatally impaired. (After all, virtually all competitors -- no matter how large -
4 - require interconnection with and use of VZ's facilities.) The Commission
5 should recognize that if competitors continue to require regulatory protection
6 from VZ in New York -- where now millions of customers are served by CLECs -
7 - then they certainly require an equal degree of protection in Rhode Island.

8

9 **B. RECOMMENDED MODIFICATIONS TO VZ'S ALTERNATIVE**
10 **REGULATION PLAN**

11

12 **Q. DO YOU RECOMMEND THAT VZ PROPOSAL BE MODIFIED TO**
13 **PROTECT AND STRENGTHEN COMPETITION?**

14 A. Yes. In view of the above discussion, I recommend a number of provisions that
15 will protect and strengthen competition in Rhode Island. As the Commission may
16 note, my recommendations follow in large part the provisions agreed to by VZ in
17 New York. The reasons for this are twofold.

18

19 First, I generally agree with the approach taken by the parties in New York and
20 believe that the modifications made to VZ's proposals were appropriate.

21

1 Further, VZ is a party to the Joint Proposal in New York, and as such, *agrees* with
2 the provisions in the Joint Proposal that protect competition in New York.
3 Presumably, if VZ agreed to these provisions in New York, it ought to agree to
4 them here in Rhode Island as well.

5

6 **Q. PLEASE STATE YOUR SPECIFIC RECOMMENDATIONS.**

7 A. The modifications I recommend are the following:

- 8 -- VZ should not be allowed to price-discriminate among similarly situated
9 retail customers. Any pricing proposal that VZ offers to one set of retail
10 customers, it should be required to offer to similarly situated customers.
11 This prevents VZ from selectively targeting just CLEC customers -- with
12 excessively inexpensive product offerings that CLECs cannot match.
13
- 14 -- VZ should not be allowed to lower any retail price for which it is seeking
15 pricing flexibility below a price floor set no lower than the imputed cost of
16 providing the service. (An appropriate imputation test is discussed below.)
17 This provision would limit VZ's ability to place dependent CLECs in an
18 anti-competitive price squeeze.
19
- 20 -- To promote facilities based competition, the Commission should order VZ to
21 offer a hot-cut NRC at a rate of no more than \$35-- the rate at which VZ is
22 offering hot-cuts in New York.
23
- 24 -- VZ should commit to continue to offer the set of UNEs it is currently
25 offering.
26
- 27 -- VZ should commit itself to introduce -- upon the request of CLECs -- in
28 Rhode Island the outcome of the NYPSC Task Force regarding the
29 promotion of competition in NY.
30

31

32 Further, the Commission should recognize that VZ's request for pricing flexibility is
33 premature in the sense that it is predicated on the further development of competition
34 even though the Commission's TELRIC proceeding -- the outcome of which

determines how viable competition will be in the future -- has not yet been completed. That is, VZ's petition here is "*placing the card before the horse*." In view of this, VZ should be required to commit itself to a number of provisions.

They are the following:

-- VZ should commit itself to a good faith effort to establish UNE prices that permit efficient local competition. At a minimum, there should be a rebuttal presumption that updated UNE prices be lower rather than higher than current UNE prices.

-- The terms and conditions under which unbundled network elements and interconnection services are available in New York are presumptively just and reasonable in Rhode Island *if conditions are reasonably comparable*. This means that *in those situations* VZ should commit itself to charge rates no higher than those charged in New York. (For example, if certain non-recurring charges are based on activities that involve the same OSS facilities as used for CLECs in New York, then rates no higher than those charged by VZ in New York should apply.) In the TELRIC proceeding, when CLECs recommend adoption of certain rates that prevail in New York, VZ should have the burden of proof to show that situations in Rhode Island are not comparable to those in New York and demonstrate why costs and rates should be higher in Rhode Island.

Q. PLEASE DISCUSS YOUR RECOMMENDATION FOR HOW AN IMPUTATION TEST SHOULD BE PERFORMED.

A. I recommend that the imputed costs used to establish a price floor below which VZ would not be allowed to set retail rates includes at a minimum the following *two* cost components:

(a) *Imputed costs of all the UNEs used to provide the service.*

This should be calculated by multiplying the quantity of the UNEs used to provide the service *times* the UNE TELRIC prices. Also included should be some recognition of the non-recurring charges to order UNEs.

1 (b) *A measure of minimum efficiently incurred retail related costs.*
2 An appropriate proxy for these retail costs could be established by using the
3 Commission approved percentage for resale discounts. The Commission
4 should recall that the resale discount is calculated based on VZ's retail
5 related expenses.
6

7

1 **IV. COMPETITIVE MARKET FORCES ARE DETERIORATING**
2 **AND MAY NOT BE SUFFICIENT TO CURTAIL VERIZON'S**
3 **MARKET POWER**
4

5 **Q. WOULD VZ HAVE THE COMMISSION BELIEVE THAT LOCAL**
6 **COMPETITION IS FLOURISHING IN RHODE ISLAND?**

7 A. Yes. The testimonies of VZ witnesses Mr. Silvia, Mr. O'Brien and Dr. Taylor, all
8 repeat the assertion that competition is strong and flourishing in Rhode Island.
9 Testimonies have been filed by VZ witnesses in other jurisdictions (New York and
10 Massachusetts) that similarly assert that CLECs are gaining ground and that
11 competition is strong and vibrant. These assertions, however, are at odds with reports
12 in media and financial papers that describe a very different picture. I believe that
13 VZ's representations are unwarranted and, in fact, dangerous. As my analysis will
14 demonstrate, the CLEC industry is in not nearly as a good a shape as VZ is suggesting.
15

16 **Q. HAVE YOU PERFORMED A FINANCIAL ANALYSIS THAT MAY**
17 **ILLUSTRATE THAT THE COMPETITIVE INDUSTRY IS NOT NEARLY**
18 **AS VIBRANT AS VZ WOULD HAVE THE COMMISSION BELIEVE?**

19 A. Yes. Attached to this testimony is an analysis that calculates the dramatic change in
20 market value of the CLEC industry over the period of December 31, 1999 through
21 August 28, 2002 based on the value of the common shares held by investors. For the
22 IXC and CLEC industries, the total decline in market capitalization over this period is

1 a staggering 88 percent.²⁰ By contrast, VZ experienced a decline in market
2 capitalization over the same period of *only 44 percent*, a percentage roughly
3 comparable to the decline in the S&P 500 Index.

4

5 **Q. PLEASE DESCRIBE IN MORE DETAIL HOW YOU CALCULATED THE**
6 **CHANGE IN MARKET CAPITALIZATION.**

7 A. As noted, this change in value was determined from December 31, 1999 to
8 August 28, 2002.

9

10 QSI created an analysis of 44 companies which comprise the vast majority of
11 publicly traded CLECs and the four RBOCs to demonstrate the disparate financial
12 strength of new entrants versus incumbent carriers. Market capitalization as of
13 December 31, 1999 was used as the baseline value in this analysis for two
14 primary reasons: (1) this point in time was still within the bull market period
15 before the first significant market correction took place in the first quarter of
16 2000; and (2) the components necessary to calculate market capitalization,
17 common shares outstanding and market price, were both readily available from
18 publicly available sources such as websites that provide current and historical
19 price quotes and Securities Exchange Commission (“SEC”) filings.

20

²⁰ Attachment II lists the companies for which the change in market capitalization has been calculated.

1 The companies included in the analysis were classified into three categories:
2

3 **(1) CLECs & Wholesale Suppliers**

4 This category includes CLECs and wholesale suppliers. Not included are the
5 CLEC divisions of the major IXC – they are included in the third category
6 described below. (The companies included in this category are identified in
7 Attachment 1.)
8

9 **(2) RBOCs**

10 This category includes the four RBOCs: Qwest, SBC, BellSouth, and Verizon.
11

12 **(3) Major IXCs – CLECs and Carrier's Carriers**

13 This category includes the major IXCs: Williams Communications, Level 3
14 Communications, Global Crossing, Sprint, WorldCom, and AT&T.
15
16

17 The Debt to Equity ratio was also determined for each company over the same
18 time period to measure changes in relative financial strength based on the amount
19 of debt used to fund operations versus stockholder's equity. Large ratios or ratios
20 that increase over time indicate declining financial strength as debt becomes a
21 larger component of the firm's capital structure. This can be attributed to a
22 greater use of debt as equity markets dry up, declining stockholder's equity as a
23 result of accumulated operating deficits, or a combination of both.
24

25 **Q. PLEASE DISCUSS THE RESULTS OF YOUR ANALYSIS.**

26 A. The analysis demonstrates that the competitive carriers have suffered serious financial
27 setbacks over the last two and one-half years. The decline in market capitalization for
28 VZ relative to CLECs and IXCs is summarized as follows:

TABLE 1

	DECLINE IN MARKET CAPITALIZATION	% DECLINE IN MARKET CAPITALIZATION
CLECs & Wholesale Providers	\$ (157.6) Billion	- 91%
VZ	\$ (67.2) Billion	- 44%
Major IXC - CLEC / Carrier's Carrier	\$ (396.1) Billion	- 87%

A more detailed breakdown of the decline in market capitalization for these three categories of carriers is found in Attachment 1.

Further, of the 40 companies comprising the CLEC and IXC categories (Categories 1 and 3), 18 have filed for bankruptcy protection since December 31, 1999 with seven of these filings occurring in the last six months.²¹ A few of the carriers that initially filed for protection have since closed down their operations and sold off their assets to competitors. The number of CLECs and IXCs that have reported negative stockholders' equity due to accumulated operating deficits increased to 28 as of August 28, 2002 compared to eight as of December 31, 1999.²²

²¹ See detailed listing of bankruptcy filing dates on Attachment II.

²² The 28 carriers with Stockholder's Deficits as of August 28, 2002 include carriers that have filed for bankruptcy since December 31, 1999.

1 **Q. IN VIEW OF THE NATIONAL DECLINE IN THE CLEC INDUSTRY,**
2 **SHOULD THE RHODE ISLAND COMMISSION BE CAUTIOUS IN**
3 **GRANTING VZ EXCESSIVE PRICING FLEXIBILITY?**

4 A. Yes. Contrary to VZ's claims, all is not well in the CLEC industry. This means
5 that the Commission cannot generally rely on the CLEC industry to protect the
6 ratepayers from VZ's efforts to raise prices. Further, the Commission should
7 recognize that carriers operating in Rhode Island are not insulated from the
8 financial difficulties of the CLEC industry and that for the foreseeable future most
9 CLECs will remain dependent on VZ for unbundled network elements and
10 interconnection services. As discussed, this dependency makes the CLECs
11 extremely vulnerable to anti-competitive pricing strategies that VZ could employ
12 under its Alternative Regulation Plan. To be sure, if the Commission approves
13 VZ's proposal, then the long-term viability of CLECs that use VZ's UNEs is
14 seriously impaired.

15

16 **V. CONCLUSION**

17

18 **Q. WHAT ARE YOUR RECOMMENDATIONS**

19 A. Verizon is still the dominant firm in local exchange markets in Rhode Island.
20 Further, as demonstrated, the CLEC industry remains extremely vulnerable to
21 anticompetitive pricing strategies but VZ's proposal includes no protections.

22

1 I recommend that the Commission modify VZ's proposal as outlined in this
2 testimony (see, section Summary of Recommendations.)
3

4 **Q. DOES THIS CONCLUDE YOUR TESTIMONY?**

5 A. Yes, it does. A summary of my testimony was provided in the introduction to this
6 testimony.
7
8
9
10